

REMARKS BY ELMER B. STAATS
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RESOURCE SCARCITY IN OUR
INTERDEPENDENT PUBLIC SECTOR:
CHALLENGES AND OPPORTUNITIES



It is a pleasure for me to be here today and have the opportunity to meet with some of the Nation's outstanding civic leaders. The theme of your Conference - "Constructive Response to Fiscal Constraint" - couldn't be more appropriate for a period when all levels of government are being pressed to do more with less. Clearly, the job of managing any organization experiencing fiscal decline is a difficult and unrewarding one. Growth is a creative force that enables managers and political leaders alike to create goodwill by expanding opportunities and programs for some or all without taking away resources from anybody.

SCARCITY AS AN ASCENDENT NATIONAL THEME

In this country, we have grown up in an economic and political system which has extolled growth as a benchmark of organizational success. In the 1960s expansion and profitability came to those firms whose products and marketing efforts were most successful. Similarly, in the world of bureaucratic politics, program managers have gained advancement by expanding their programs into veritable empires.

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In many areas of national life, we are now facing what Kenneth Boulding has called the "Era of Slowdown." As a Nation we have learned the limits of growth inherent in our reliance on nonrenewable energy sources and our desire for a clean, healthy natural environment. We are just beginning to sort out the changes that scarcity has wrought for our entire economy and social structure. The need to conserve energy, for example, has intensified conflict among various sectors of the economy, and has induced strain in a political process unaccustomed to dealing with the politics and economics of less.

Apprehension over the effects of scarcity have begun to affect the personal expectations and goals of the American people. According to recent public opinion polls, 62 percent of Americans now believe that we are entering an era of enduring scarcity. This feeling is reflected in a growing public pessimism about the future. For the first time, a majority of Americans now believe that the future will be worse than the present. This is a marked turnaround from data recorded in earlier polls taken in the 1950's and 1960's showing bright expectations for the future.

State and local government cutbacks

Similarly, the public sector of this Nation is now beginning to experience the organizational pains associated with slow growth and decline. In the years since 1950, explosive growth has characterized the State and local

sector, much of which was fueled by Federal funds. In fact, during the 10 year period ending in 1974, State and local governments became the Nation's leading growth industry as expenditures and employment increased at a faster pace than the Federal Government as well as the private sector. The State and local share of the GNP nearly doubled between 1954 and 1974. However, since 1975, a slowdown in the rate of growth has occurred. State and local expenditures fell from 15 percent of GNP in 1975 to 14.3 percent for 1979.

Several years before passage of California's Proposition 13, the declining economies of many of our major central cities led to harsh budgetary realities. Cities like New York and Detroit began to chart a grim budgetary course that is now being closely studied by many communities under the fiscal gun of angry taxpayers. In fact, in 1976, more than half of the Nation's 20 largest cities reduced the number of employees on their payrolls.

Passage of Proposition 13 by California voters in June 1978 triggered a new wave of tax reductions in jurisdictions throughout the country.

Proposition 13 reduced local property taxes to one percent of market value, reducing California's local governments' annual tax revenue by about \$6 billion. While increased State fiscal assistance prevented massive local spending cuts, California local governments have experienced a material reduction in their spending growth rates - from about 10 percent annually to 7 percent. Following California's lead, taxpayers in 12

States voted approval of either tax or spending limitation measures in November 1978. Measures passed in two States-- Nevada and Idaho are similar to Proposition 13 in that they would drastically cut back property taxes. Other measures put a ceiling on future State spending by tying increases to changes in per capita income or the consumer price index. Some States, like California, tightened their procedures to make it more difficult for the legislature to approve future tax increases.

It seems clear that most State legislatures have already gotten the taxpayers' message. According to the Tax Foundation, for the first time in 4 years aggregate State taxes were reduced by a net of \$2.3 billion in 1978, and may be further reduced by \$3 billion in 1979 (excluding California). In 1979, 37 States voted some kind of net tax reduction. Thus, it seems likely that the future growth rate of State and local government will be slow.

If public opinion polls are any guide, the desire of citizens to constrain government growth and limit their burdens may not abate soon. With continuing inflation feeding the public's perception that the cost of living is rising faster than their incomes, the growing tax bite stands out as the one item subject to popular control. Indeed, taxes on the average family income have doubled between 1953 and 1977, from 11.8 percent to 22.8 percent of annual earnings.

In addition to believing it is paying more for government services, the majority of the American public now believes it is getting less. Public confidence in the productivity and responsiveness of government has plummeted in recent years. The percent of the public believing that government spending is excessive has grown from 42 percent in 1958 to 78 percent in 1978. Perhaps more alarming is that only 33 percent of the public now feel that they can trust their government to do "what is right" most of the time, down from 75 percent who felt this way in 1958.

Cutbacks at the Federal level

Federal policymakers are equally concerned with this public disaffection towards government. The polls reveal that the Federal Government is perceived by most to be more wasteful and distant than State and local governments. Thus, it is not surprising that Proposition 13 and the widespread passage by States of resolutions calling for a constitutional convention to balance the Federal budget sparked renewed budget cutting efforts in Washington and heightened interest in oversight of program effectiveness and productivity improvement. Indeed, the Federal budget deficit is being reduced from \$48 billion in Fiscal Year 1978 to an estimated \$29 billion for 1980. Federal outlays as a percent of GNP have now declined for the past 2 years.

These resource constraints at the Federal level have sparked renewed interest in improving the management and productivity of the Federal work force. Passage of the Civil

Service Reform Act, including provisions tying pay more explicitly to measured performance, and establishment of the U.S. Office of Personnel Management signify a new and promising commitment of the Federal Government to improve the productivity of its work force. Also, there is a growing concern for evaluating the effectiveness and efficiency of existing programs before embarking on new, untested, and expensive policy initiatives. We in the General Accounting Office have increasingly been called upon to report to the Congress on the effectiveness of major Federal programs. Many Federal agencies have established or strengthened in-house evaluation systems to help them better monitor and manage their programs.

Intergovernmental Interdependence

Thus, all three levels of government now must share the organizational pangs associated with managing under conditions of resource scarcity - a process that one scholar aptly characterized as "administering organizational sacrifice."

More importantly, all three levels of government now share a mutual interdependence in administering programs that is unprecedented in our Nation's history.

In earlier and simpler times the responsibilities of governments in the United States were more clearly defined than they are today. Local, State, and National government worked fairly independently of each other. With the increase beginning in 1955 of Federal financial assistance to State

and local governments from \$3 billion to an estimated \$85 billion for 1979, this independence of governments began to change. Each type of government relies more and more today on cooperation with others. A myriad of programs administered by 52 Federal departments, agencies, and commissions are now carried out by 50 States, 3,000 counties, nearly 37,000 cities and towns, and innumerable organizations closely associated with the Federal Government.

The interrelationship among Federal, State and local governments has become increasingly intricate as Federal funds have grown to account for some 25 percent of total State and local expenditures compared with 10 percent in 1955. The Federal Government now provides categorical assistance to States and localities under about 500 programs. In contrast to the categorical programs, which represent the bulk of Federal assistance, we also have five block grant programs and general revenue sharing. Today, practically every major State and local service is affected by this growing Federal fiscal and regulatory presence, as Federal grants are now available for State and local activities as diverse and localized as police protection and rural fire protection.

Problems Caused by the Federal Grant System

I don't need to tell those of you with long acquaintance with municipal governance that citizens' initiatives to reduce government waste and improve efficiency are a proud part of our civic tradition. Harsh budget cuts, forced by economic

depression, are an unfortunate part of the histories of many American cities, including Detroit's own bankruptcy of the 1930's. However, budget cuts and austerity at the State and local level now must be instituted against a new backdrop of the intergovernmental interdependence epitomized by our Federal grants system. Through the grant system, the Federal Government's policies are a new factor that must be dealt with by State and local managers seeking to negotiate an equitable distribution of austerity among numerous competing local groups.

Virtually all Federal grant programs have laudable objectives, but from the viewpoint of elected and appointed officials, their growth has caused detrimental side effects on the State and local management system. Each program tends to build its own constituency, or "functional autocracy" - a phenomenon which balkanizes government. Local specialists in education, health, and housing, for example, interrelate with their counterparts in the States and in the Federal agencies. In many cases, the elected State-local leadership - legislative bodies, mayors, county executives, and Governors - are bypassed. Such bypassing can deal a deadly blow to the goal of our intergovernmental assistance system to relate effectively the efforts of a city, or of a State, or of a Nation into cohesive strategies for meeting each level's problems.

Other undesirable features of the fragmented Federal assistance system which are often mentioned include:

- Excessive administrative requirements and "red tape."
- An inability of the Federal Government to respond promptly to changing priorities and circumstances.
- A situation where the Federal level is providing overlapping sources of funds for the same or closely related purposes.

During times of resource scarcity at the State and local level, these intergovernmental management problems tend to become more burdensome.

Federal grants and fiscally declining communities

In considering the fiscal impact of Federal grant policies on States and localities facing austerity, a key question emerges from the State and local perspective: Is the Federal Government part of the problem or part of the solution?

GAO's evaluations provide strong evidence that both the short and long term expenditure impacts of Federal grants add to expenditure pressures experienced by local government and, in fact, may contribute to fiscal instability. More importantly, by penalizing expenditure reduction with loss of Federal grant funds, the grant system constrains and distorts the process by which State and local budgets are reduced.

As a result, many disillusioned communities in search of "free" Federal money have learned through bitter experience an important corollary to a fundamental law of economics: there is no such thing as a free Federal grant.

Grants stimulate public spending in a variety of ways. First, categorical grants are premised primarily on the notion that the State and local sector is not spending enough for services or programs with high national interest. In providing financial assistance for a program, a grant essentially entices State and local governments to participate in a program that they otherwise would not have sufficiently funded from their own resources.

While this accomplishes the national intent, as the number of grant programs has grown, State and local governments have been enticed into participating in a growing array of programs with high national priority. While Federal funds are available to defer partial program costs, grant programs typically force State and local governments to assume their financial burden over the long term.

Much of the expenditure impact can be explained by the political processes of State and local governments. By arousing new expectations and dormant constituency groups, Federal grants can induce state and local governments to spend more than they previously considered necessary for particular programs.

Also, many Federal seed money programs by design only fund initial costs, forcing State and local governments to fully fund future year program costs or face the unenviable task of terminating programs that have gained a clientele of their own. Other major Federal programs, such as the sewage treatment construction programs, fund initial capital construction, but leave operating and maintaining the new facilities to be funded entirely from State and local sources.

But even more of the expenditure impact can be attributed to provisions of the grants themselves or to the "strings" which require additional spending as a condition for receiving grants. These grant provisions often make good sense when viewed from the perspective of each Federal grant program. Indeed, managers and advocates of each program seek to promote increased expenditures for their programs wherever possible. But the impact of four types of provisions - mandates, matching requirements, maintenance of effort requirements, and formula provisions - can be particularly onerous on declining communities.

Mandates

Burdensome and costly Federal regulations imposed as conditions of Federal assistance programs work to further increase State and local expenditures for grant programs. While local governments are not directly required to comply, the potential loss of Federal assistance is usually punishing enough to force compliance.

A recent comprehensive study of mandates found that 1,036 Federal mandates exist in laws and regulations as conditions for the receipt of Federal grant funds. The costs of implementing these mandates attached to Federal grant programs were paid from local revenues in over 45 percent of the cases. The study found that over 900 of the mandates were enacted during the 1970's.

The stimulative impact of Federal grants on State and local budgets is intensified by grant policies linking the level of Federal assistance provided to State and local fiscal effort:

Matching requirements - 60 percent of Federal grant programs require State and local governments to provide a specified nonfederal share of grant costs as a condition for receiving Federal assistance.

Maintenance of effort requirements - to prevent fiscal substitution, many Federal grant programs require grantees to maintain a prior fixed level of effort in order to prevent grantee fiscal retrenchment using Federal funds. Other programs impose nonsupplanting provisions which require Federal funds to be used to supplement nonfederal funds that would otherwise be made available for the program in the absence of the Federal grant. Thirty-seven of the 52 Federal grant programs

with over \$100 million in fiscal year 1978 funding have maintenance of effort requirements. Formula allocations - of the 93 Federal formula grant programs, 32 reward high grantee expenditures or taxing effort in allocating Federal funds.

In effect, these Federal policies reward increased spending in Federally favored areas. For States and localities with growing budgets, Federal grants and their costs can be absorbed without real sacrifice from other locally funded programs. For jurisdictions experiencing budget cuts, however, these Federal grant policies can become an important constraint further complicating the task of managing conflict under austerity. Jurisdictions that must cut spending are faced with a cruel dilemma.

They can:

- (1) Cut spending for Federal grants and risk loss of Federal grant money, imposing a further loss of services on troubled local economies.
- (2) Cut spending disproportionately in non-federally funded services in order to avoid triggering the loss of Federal funds, thus distorting local spending priorities.

Our evaluation studies indicate that many jurisdictions choose to distort their own priorities rather

than lose Federal assistance. In some cities, this means cutting basic services that are not federally funded such as police, fire, or sanitation. While local governments may increase or maintain their Federal revenues this way, they also increase their dependency on Federal dictates and directives and suffer a corresponding erosion of their discretion over policies and services. Budget strategies that protect national priority programs at the expense of locally funded programs may impair the capacity of local governments to respond to the unique needs of their citizenry. The ultimate danger is impairing the confidence of citizens in the capacity of government to respond to their own perceived needs.

Thus, I am concerned that our intergovernmental grant system may not only complicate the considerable task of managing government under fiscal austerity, but may in fact further erode the voters' confidence in their government's ability to faithfully reflect and execute local priorities. This may further promote the political alienation that triggers tax revolts in the first place. Indeed, one of the great ironies of the recent tax revolt may be that movements originally sparked by disaffection and alienation of government from the people may place further distance between government and the people by increasing their dependency on external funding sources and political constraints.

OPPORTUNITIES FOR CHANGE

A public sector whose basic rewards and incentives were framed in an era of growth will be challenged to adjust to

the new era of slowdown or austerity. The public administration community and the citizenry alike need to adjust their expectations and values to reward creative management of stress and austerity.

All three levels of government must recognize the opportunities inherent in austerity to improve the effectiveness and responsiveness of public programs. Specifically, chances for positive Federal actions have improved recently in three areas of vital interest to communities experiencing fiscal and economic problems:

- Federal grant reform;
- productivity improvement; and
- financial management.

Federal grant reform -

The need for constructive reform of the intergovernmental grant system has become more apparent since passage of Proposition 13. Clearly, Federal grant policies which penalize expenditure reductions should be re-examined. It is encouraging to note increasing Federal interest in analyzing the fiscal impact of Federal mandates imposed on State and local governments. New legislation recently introduced with broad support in the House of Representatives would require Congressional staff to analyze the cost impact of proposed legislation on State and local governments, similar to the "fiscal note" process used in some States. Renewed concern for the management problems fostered by our fragmented categorical grant system has heightened interest in grant reform, particularly:

--Consolidation of the multitude of categorical grants into broader purpose programs.

--Standardization and simplification of the confusing welter of Federal cross-cutting grant requirements.

--Reduction of Federal reporting and paperwork burdens imposed on grant recipients.

Last month, I testified before the Senate on proposed legislation which would help realize these reform objectives. The Office of Management and Budget is completing a comprehensive assessment of opportunities for improving the management of the Federal grant system. This study may result in Federal actions to better define its relationships with grantees, centralize and standardize the management of Federal grant programs, and hopefully, reduce the intrusiveness of Federal grants in the State and local management process.

Productivity improvement

Productivity improvement has become a more relevant strategy for governments forced to do more with less. Productivity improvement programs have led to significant dollar savings and improved performance in many of our Nation's cities. In a recent study, however, we found that this strategy is not widely used, especially by States and localities with fiscal problems. Our study did conclude that the Federal Government can encourage

more State and local interest by providing critical financial and technical support for State and local productivity improvement efforts. I am encouraged by recent Administration proposals which would strengthen Federal leadership in this area and offer a broader general management improvement program for State and local governments.

Financial management improvement -

Finally, budget crises have intensified interest in improving State and local financial management practices. Some of New York City's fiscal problems are directly attributable to weaknesses in accounting and budgeting practices. The financial reports of many government organizations not only are unclear but do not reflect all important assets and liabilities. State and local compliance with established accounting principles is uneven at best. A major effort is ⁴³⁷⁴ now underway by the National Council on Governmental Accounting to redefine accounting principles and standards for State and local governments. Due to the Federal interest in accurate State and local financial reports for grant programs, Congress has expressed interest in establishing a federally chartered organization to set uniform accounting principles for State and local governments. Ultimately, the primary beneficiaries of accurate accounting systems will be State and local managers and the taxpayers themselves, who will have access to full information on the total costs of competing policy options.

Auditing is another area of financial management that has received much recent attention at all three levels of government. As public confidence in government has waned, government at all levels has devoted increasing attention to questioning itself. The scope of government auditing has expanded in recent years. For example, in GAO we have placed more emphasis in recent years on the evaluation of program efficiency and program results as well as more traditional checks on financial mismanagement and fraud. As a result, audit findings have now become a central tool used by the electorate to hold government accountable to the people.

Auditing organizations at the Federal level, of course, have much in common with State and local auditors. The state of the art in auditing public programs is by no means fixed, especially when evaluating the effectiveness or ultimate impact of complex government programs. Furthermore, due to the intergovernmentalized aspects of major public programs, auditors at all three levels of government frequently find themselves auditing the same program. Thus, we have found that there is much to be gained through cooperative efforts among all levels of government. To enhance prospects for improved auditing throughout the entire public sector, Intergovernmental Audit Forums have been established at the National and regional levels to provide a focal point for joint projects and information transfer among Federal, State, and local government auditors. A recent example of intergovernmental audit progress has been the development of

a standard guide for comprehensive financial and compliance audits of organizations receiving Federal assistance from a multitude of grant programs. GAO, in cooperation with the Intergovernmental Audit Forums, took the lead in developing this guide, which could help eliminate some of the inconsistencies arising from the uncoordinated audits by Federal agencies of each separate grant program received by a single grantee.

CONCLUSION

In closing, I think that resource scarcity presents opportunities to those of us in and out of government who expect better performance and greater effectiveness from our public sector. Resource cutbacks should increase the need for organizational self-evaluation and criticism. The value of evaluation groups such as GAO at the Federal level should become more apparent as the government and the public alike search for ways to maintain or increase services with less. We at GAO have produced innumerable evaluations of Federal programs where we have recommended actions leading to specific dollar savings or improved program effectiveness. For example, we recently pointed out that the Federal Government could recover as much as \$3 billion if we instituted more efficient debt collection practices. I know that strong evaluation groups exist at the State and local level as well.

At the Federal level, we should remove needless constraints imposed by our grant system on local government's ability to evaluate and cut. Furthermore, we should expand

Federal support for building local government's evaluative capacity. A strong intergovernmental partnership forged by a mutual commitment to more effective government may be the best hope for managing a public sector in the throes of resource scarcity.

However, self-evaluation is not necessarily a natural response for governments cutting back. Indeed, we have observed that some local governments in fiscal distress cut their analytic and evaluation groups before reducing more visible basic services. Self-evaluation must be supported by a citizenry concerned with the effectiveness of its government. In the final analysis, enlightened citizens groups, as represented by your organization, are an essential foundation for an effective public sector.



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Statement of
Elmer B. Staats
Comptroller General
of the United States

before the

01 Senate Armed Services Committee

on

The [Navy's Service Life Extension Program] (SLEP)

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1 - 1 Mr. Chairman and members of the Committee, we are
2 pleased to be here today to discuss our analysis of the
3 Navy's cost study on the proposed service life extension
the Philadelphia Naval Shipyard or Newport News Shipbuilding 641
and Dry Dock Company, a private yard. Let me say at the C. 9 86
outset that we believe our prior report was and remains
valid. As stated in our report, there was a decided cost
advantage in favor of Newport News.

I would like to briefly explain the background and
our involvement in this issue. Then I plan to address the
most recent Navy study and comment on some of the concerns
raised by the Deputy Secretary of Defense. I would also
like to call your attention to appendixes II and III, showing
our position in more detail as it impacts the original and
revised Navy study and our evaluations and comments on the
study made by William N. Lanen, a graduate student at the
Wharton School, for the City of Philadelphia.

BACKGROUND

The Navy is embarking on a service life extension pro-
gram for four of its older carriers with potential follow-on
ships beyond the four. The initial question was where should
this work be done--in the Philadelphia Naval Shipyard or in a
private shipyard. The Navy considered splitting the work,
but felt the advantages in learning curve and work force

management clearly pointed to doing all four carriers in one yard over a specified period of time.

In the initial cost study, which the Navy completed in June 1978, a number of assumptions and concerns were expressed. The more important included:

1. Rapid buildup at Philadelphia could be a problem.
2. Philadelphia, in order to accomplish the work within the compressed timeframe would have to use 1474 members of the ship's crew.
3. The Newport News shipyard could perform the first carrier; but not the three follow-on carriers, because of congestion in the yard. (The Navy now concludes that Newport News can handle the entire work.)
4. Newport News could not, or would not use the ship's crew.

GAO was asked to review the cost study and issued its report on September 22, 1978. Prior to this date we met with interested members and staff members of the two affected yards.

In summary GAO felt that the cost study should be adjusted in several areas, the net effect was to provide Newport News with a greater cost advantage than the Navy had shown.

Navy officials generally concurred with our adjustments and conclusions. We recommended that in view of the sizeable cost differences, the Navy reevaluate its position to award the carrier to Philadelphia.

We also believed that a new study was needed which should evaluate (1) whether it is possible to obtain the needed skilled shipbuilding workers at Philadelphia for the program, (2) whether there is a variance between the productivity at public and private shipyards, (3) whether or not the ship's crew should be used at Newport News, and (4) the impact of the program on the planned modernization program at the Philadelphia Naval Shipyard.

The requirement for such a study was mandated by Section 811 of the FY 1979 Appropriation Authorization Act (PL. 95-485). Paragraph (a) (1) reads as follows:

"the Secretary of the Navy conducts a comprehensive least cost approach study (A) comparing the cost of carrying out such programs at public shipyards with the costs of carrying out such programs at private shipyards, and (B) evaluating such other factors as the Secretary of the Navy considers should be taken into account..."

CURRENT NAVY STUDY

After reviewing the Navy's revised cost estimates and other relevant factors, the Chief of Naval Operations and the Secretary of the Navy stated that

--costs should not be controlling.

--the availability of facilities at Newport News has been assured.

--Newport News has indicated a willingness to accept the Navy crew to do the work should it be required.

--relief from civilian end-strength limitations would be necessary before the Saratoga could be sent to Philadelphia.

More specifically, the Chief of Naval Operations said that the large cost differences in favor of Newport News, taken in aggregate with other relevant factors such as personnel morale, the ability of Newport News to take all four SLEP ships without interference with other Navy work, and the severe limitations on the Navy's civilian end-strength lends strong support to reversing the earlier decision and assigning the Saratoga to Newport News.

On January 25, 1979, the Deputy Secretary of Defense submitted to the Senate and House Armed Services Committees

the revised Navy study and his conclusion that the carrier work should be done at the Philadelphia Naval Shipyard.

The Secretary states that costs should not be the determining factor, since at best they are soft and not conclusive. He states the following factors were also considered:

- congestion at the Newport News yard,
- availability of facilities at Newport News,
- serious pending labor controversies at Newport News, and
- advantage of maintaining an additional East Coast yard with carrier SLEP and overhaul capability.

He concludes, and I quote:

"In summary we continue to feel that Philadelphia Naval Shipyard is the logical place to perform the SARATOGA SLEP and that the cost study and other non-cost factors considered have not provided a sufficient basis on which to change the decision the Secretary of the Navy made last April."

GAO has not had an opportunity to review in detail the revised study, however, we do not have serious problems with the Navy's cost estimates. As pointed out earlier we had reached substantial agreement on the prior data. The paramount question here is what assumptions should be used,

and what data should be compared. Much confusion has been created by comparing unlike items. This is understandable when one considers the number of cost alternatives presented. In essence we have six different assumptions for Philadelphia and two different assumptions for Newport News. These include three sets of assumptions and figures for Philadelphia with or without wage reform, and two assumptions for Newport News, one reflecting full use of the ship's crew labor, the second non-use of ship's crew labor. We have shown these various cost alternatives in Appendix I.

As can be seen from the data which was prepared by the Navy one could argue that Newport News has a cost advantage if the ship's crew were used of either \$80 million or \$37 million depending on what assumptions are used for Government retirement benefits and wage reform.

The Secretary of the Navy in his letter used the \$37 million figure as being the net difference which assumed a 7.1 percent retirement factor and wage reform.

We believe the following assumptions and resultant cost factors should be used in the comparisons of the two yards.

1. Use of ship's crew--The Newport News option without ship's crew is endorsed by the Chief of Naval Operations

for morale purposes. We have previously stated our preference for this option. This unfortunately was not one of the Navy options at Philadelphia, since the crew is needed as a labor force at Philadelphia to meet the program schedule. If the Newport News option without crew were selected, then for comparison purposes, one would have to make the same assumption for Philadelphia. This comparison has not been made for Philadelphia, but if it were, the use of civilian rates would increase Philadelphia's costs thus further widening the gap in favor of Newport News. While this would be the preferred option we have not used it, since according to the Navy it has no choice but to use the ship's crew to meet the schedule.

2. Civil Service retirement factor--Our prior report pointed out that the 7.1 percent cost factor used in past analyses is grossly understated and we believe the current Office of Management and Budget rate of 20.4 should be used. In a prior report to the Congress, we recommended an even higher figure of 24.7. The cost difference between the 7.1 percent and 20.4 percent amounts to about \$27 million.

3. Wage board reform--In prior reports we have endorsed the concept and need for wage board reform. Also Office of Management and Budget guidance requires that for estimating purposes for Fiscal Year 1979 and subsequent years passage of wage board reform legislation shall be assumed. While we showed both figures in our prior report, it may be more realistic to use the cost figures without wage board reform, because passage of legislation does not appear to be imminent. The cost differences between the two assumptions amounts to about \$19 million.
4. Corporate taxes--Office of Management and Budget Circular A-76 requires that for cost comparisons, between Government and private facilities, corporate taxes lost be included as a factor. The amount included as corporate taxes lost in the latest Navy study is \$18.1 million.

Given the above stated assumptions we believe the current Navy figure of \$80 million in favor of Newport News is the more realistic. I want to point out that the Navy, in its revised study, adjusted the Philadelphia estimates downward by \$36 million, primarily in the labor category. We have not evaluated the supporting data for this adjustment, but this single item is the major difference between the cost figures we used in our report and the current Navy figures.

As noted earlier in my statement the Navy in its first study had certain concerns. In the revised study these concerns were no longer considered valid. The Deputy Secretary of Defense has, however, raised other issues which are addressed below.

SHIPYARD CONGESTION AND
AVAILABILITY OF FACILITIES

When the Secretary of the Navy made his initial decision to perform the service life extension for the Saratoga at the Philadelphia Naval Shipyard, the Navy assumed that construction of a new aircraft carrier at Newport News would preclude that yard from accomplishing the follow-on service life extension programs because of an interference problem caused by the size of available drydocks.

The Navy made this assumption because its analysis of the facilities at Newport News was limited primarily to the facilities in the south yard which are currently used for Navy work.

Newport News told the Navy on June 22, 1978, that it had the facilities required to accomplish the four service life extension programs without conflicting with other Navy programs. Newport News said that it was willing to commit

the necessary facilities in the south and north yards for the work on the four ships provided that it received a similar commitment from the Navy.

On July 14, 1978, Newport News completed a study identifying various facility modifications required for it to handle the service life extension programs and told us that the modifications would cost about \$2.5 million in 1978 dollars. Newport News said that 3 to 6 months would be adequate for the facility modifications.

A subsequent Navy survey found that the Newport News facilities are adequate.

LABOR CONTROVERSIES

For over a week the shipyard workers at Newport News have been on strike. A major concern about the strike is its effect on the shipyard's labor rate and its impact on Navy's and our cost analysis. I have no way of telling how the strike will affect the shipyard's labor rate. But, the average labor rate that we projected at Newport News for February 1980 is 24 percent higher than the actual average labor rate for February 1978. The wage escalation projection is well above the President's wage price guidelines.

MOBILIZATION NEEDS

The Secretary of the Navy said that among the factors he considered last year that influenced his decision to assign the Saratoga to Philadelphia was the desirability of maintaining an effective carrier overhaul capability at a second East Coast Naval Shipyard. Recently the Secretary said that his desire remains unchanged, but with the availability of both Newport News and Norfolk Naval Shipyard this is not a controlling factor.

In a 1978 report 1/ we pointed out that the current size of the Navy's shipyard complex has evolved without adequate consideration of mobilization requirements. In the report we also stated that in determining its shipyard needs, the Navy should consider existing private yards.

Section 809 of the Defense Industrial Reserve Act of 1973 (P.L. 93-155) clearly states that for mobilization planning, Government-owned plants are to be held to the minimum requirements for immediate use in time of national emergency and that to the maximum extent practicable, reliance will be placed upon private industry for support of defense production.

1/Naval Shipyards--Better Definition of Mobilization Requirements And Improved Peacetime Operations Are Needed; LCD-77-450; March 31, 1978.

OTHER ISSUES

In addition to the issues I have already discussed, the Deputy Secretary of Defense cited two issues that he believed attest to the "softness" of the cost estimates; namely opportunity costs and productivity. I would like to briefly comment on these issues.

Opportunity costs

The Navy said that assigning the Saratoga to either Philadelphia or Newport News would permit management to allocate overhead costs on a broader base.

Newport News estimated that \$18.2 million in Government costs to other work would be avoided if it received the Saratoga and could distribute its fixed overhead costs over a greater direct labor base. Neither we nor the Navy have reviewed this estimate.

The Navy claims that the labor rates at Philadelphia will increase between \$20 to \$27 per day if the Saratoga is not sent to Philadelphia. The Navy, therefore, calculated that about \$44 million could be avoided by doing the work at Philadelphia. The Navy also stated that these were unofficial projections.

The Navy pointed out that although these estimates resulted in a net advantage of \$25.8 million to Philadelphia, they were not used in the study because

- a. There is no way of predicting with certainty what other work would occur in either yard in the absence of the carrier SLEP work (and the resultant overhead effects are therefore unpredictable).
- b. It is not clear that the \$18.2 million and \$44 million overhead cost estimates are comparable costs (i.e., include the same cost elements).
- c. The present study has not reflected the costs associated with equipment depreciation and/or interest expenses at Philadelphia (such costs are implicit in the overhead rates of commercial activities).

We recognize that these costs are difficult to quantify precisely but if the total costs to the Government are to be known we believe that the assumptions required to make the estimates should be stated clearly and attempts should be made to determine the costs.

There are other opportunity costs, which we also recognize are difficult to quantify, but which should be considered such as

1. The increased costs and negative morale impact of assigning the service life extension program to Philadelphia since two thirds of all Atlantic Fleet carriers are homeported in Norfolk. The Chief of Naval Operations considered this a relevant factor.
2. The advantage of assigning over 1,100 sailors to the Saratoga during the service life extension program versus making better use of these scarce manpower assets elsewhere in the fleet.
3. The effect on labor rates at shipyards from which work was pulled in order to increase the workload at Philadelphia.

Productivity

The Navy study recognizes a productivity advantage to Newport News by assuming the same amount of productive labor days at both shipyards even though many direct labor charges at Newport News are charged as overhead at Philadelphia. In commenting on the Navy study the Chief of Naval Operations said that it is reasonable to assign a productivity advantage to Newport News in view of that yard's experience in the construction and overhaul of large ships and the fact that Newport News will not be required to respond to high priority emergency work, as Philadelphia would. The Chief of Naval Operations further added that

"Though difficult to assess, the advantage is real and should not be ignored if the true comparison of costs is to be made."

According to the Navy, the advantage to Newport News is imprecise but appears to be about 15 to 20 percent. The advantage was derived primarily from a productivity comparison made for the Navy (not GAO) of submarine overhaul work done at a private (Newport News) and a public yard (Bremerton).

We recognize that to precisely determine a productivity advantage of one shipyard over another would be difficult. We believe the Navy's rationale is logical and other studies could be cited in support of this position. For example,

Booz Allen studies in 1972 and 1977, concluded that it is cheaper to construct and overhaul ships in private yards. A 1971 Ernst & Ernst study came to a similar conclusion.

In summary Mr. Chairman, we recognize that this decision is a complex one. We certainly do not claim to have all the answers. We have worked closely with the Navy in this review. As we see it, it comes down to which assumptions should be used. We have given you our reasons for and against certain assumptions. Based on the assumptions we used, we believe the current Navy figure of \$80 million in favor of Newport News is more realistic. We hope that we have helped you in sorting through a myriad of cost data.

Mr. Chairman, this concludes my prepared statement. We will be happy to answer your questions at this time.

VARIOUS COST OPTIONS
PRESENTED IN THE REVISED
NAVY STUDY

Philadelphia

	<u>Without Wage Reform</u>			<u>With Wage Reform (note a)</u>		
Civil Service retirement factor (percent)	<u>20.4</u>	<u>14.1</u>	<u>7.1</u>	<u>20.4</u>	<u>14.1</u>	<u>7.1</u>
Cost with ships force (millions)	<u>\$556</u>	<u>\$543</u>	<u>\$529</u>	<u>\$537</u>	<u>\$525</u>	<u>\$512</u>

Newport News

With ships force (millions)	<u>\$476</u>	<u>\$476</u>	<u>\$476</u>	<u>\$476</u>	<u>\$476</u>	<u>\$476</u>
Without ships force (millions)	<u>\$524</u>	<u>\$524</u>	<u>\$524</u>	<u>\$524</u>	<u>\$524</u>	<u>\$524</u>

a/Public Law 92-392 (Subchapter IV, Chapter 53, Title 5 U.S.C.) established the comparability principle for blue-collar employees. Current Government blue-collar wages are higher than comparable wages in local wage areas. Reform has been proposed, but no specific legislation is pending.

ANALYSIS OF THE NAVY'S REVISED COST ESTIMATES

<u>Location</u>	<u>Cost element</u>	<u>Amount in GAO report</u>	<u>Amount in Navy's latest study</u>	<u>Difference</u>
		------(millions)-----		
Philadelphia with wage board reform	Basic shipbuilder conversion, contract modifications, and escalation	\$389.2	\$350.7	\$-38.5
	Reserves for F-14 mbds.	5.0	5.0	0
	Government-furnished material, services, and test	67.0	67.0	0
	Military personnel	85.6	82.0	-3.6
	Facilities and training	0	2.0	2.0
	Corporate taxes lost	14.2	18.1	3.9
	Additional retirement costs (note a)	0	11.9	11.9
	TOTAL	<u>\$561.0</u>	<u>\$536.7</u>	<u>\$-24.3</u>
Philadelphia without wage board reform	Basic shipbuilder conversion, contract modifications, and escalation	\$405.5	\$368.9	\$-36.6
	Reserves for F-14 mods.	5.0	5.0	0
	Government-furnished material, services, and test	67.0	67.0	0
	Military personnel	85.6	82.0	-3.6
	Facilities and training	0	2.0	2.0
	Corporate taxes lost	14.2	18.1	3.9
	Additional retirement costs (note a)	0	12.8	12.8
	TOTAL	<u>\$577.3</u>	<u>\$555.8</u>	<u>\$-21.5</u>
Newport News	Basic shipbuilder conversion, contract modifications, and escalation	\$311.1	\$315.4	\$ 4.3
	Reserves for F-14 mbds.	5.0	5.0	0
	Government-furnished material, services and test	67.0	67.0	0
	Military personnel	85.6	82.0	-3.6
	Contract administration	3.4	3.6	0.2
	Facilities and training	0	3.0	3.0
	TOTAL	<u>\$472.1</u>	<u>\$476.0</u>	<u>\$ 3.9</u>

a/Amounts shown in GAO's report used the 14.1 percent factor for retirement. This is the additional costs using the 20.4 percent factor.

Basic shipbuilder conversion,
contract modifications, and
escalation

As indicated above, the largest difference in cost estimates between the GAO report and the Navy's revised cost estimates is in this cost element for Philadelphia. The primary reason for this difference is that the Navy decreased the daily labor and overhead rates for Philadelphia. The shipyard claimed that the daily rate would be less than previously estimated because the overhead costs would be spread over an increased direct labor workload. We have not reviewed the Navy's revised cost estimates, but did note that a similar adjustment was not made to the Newport News estimates.

The difference of \$4.3 million between our estimate and the Navy's revised estimate for Newport News resulted primarily from the Navy's decision to now assume that a portion of the work would be done in Newport News' north yard facilities. As stated on page 4 of our report, because the north yard facilities are newer, the use of these facilities increases the overhead costs. We have not reviewed the Navy's revised cost estimates.

Military personnel costs

As indicated on page 11 of our report, the Navy recomputed the military personnel costs at \$82 million using more recent cost information. We agree with the Navy's latest cost estimate.

Facilities and training

As indicated on page 12 of our report, these cost elements were not included in the Navy's original cost study, but should have been included. We have not reviewed these Navy cost estimates.

Corporate taxes lost

The difference of \$3.9 million in our cost estimate and the Navy's revised estimate resulted from the Navy's changes to the estimated costs at Newport News.

Additional retirement costs

As stated on page 13 of our report, the Navy's original estimates and our estimates were based on the Office of Management and Budget's Civil Service retirement cost factor of 14.1 percent. However, this factor does not fully recognize the total Federal retirement costs. The Office of Management and Budget has estimated that the Government's portion of the cost of retirement systems is 20.4 percent of pay. We believe this factor is certainly more appropriate and should be used in the cost comparison.

Contract administration

The difference of \$.2 million between the Navy's revised estimates and our estimates resulted from the Navy's decision to use the 20.4 percent for retirement in the revised estimates rather than the 14.1 percent factor. We agree with the Navy's revised cost estimate.

GAO's Evaluation of
William N. Lanen's Critique of GAO's
PRIOR REPORT

On January 2, 1979, William N. Lanen, a graduate student at the Wharton School, University of Pennsylvania, issued his report "A Critique of the GAO report 'Extending the Service Life of Aircraft Carriers--Where Should The Work Be Done?' " Mr. Lanen undertook this review at the request of the City of Philadelphia.

Mr. Lanen qualifies his report as follows:

- He did not have access to the Navy or GAO data, therefore had to make a number of assumptions. "To the extent that the assumptions I have used are inaccurate, the reader may substitute alternatives."
- "Because I did not have access to either the individuals responsible for the analyses or to the documents used, the process as I understand it may not reflect accurately the actual process followed." (emphasis added)
- "Before going into the detailed analysis, the reader is reminded that this review was conducted without discussing the issues raised below with those in GAO responsible for the preparation of this report nor

with any attempt to verify the consistency of the
methods employed by either GAO or the Navy with
relevant government regulations." (emphasis added)

GAO note: We have attempted to relate Mr. Lanen's figures
to those in our report, and where necessary have
made adjustments and explained the reasons for
these adjustments.

GAO ANALYSIS OF THE LANEN STUDY

<u>Location</u>	<u>Cost element</u>	<u>Amount included in the Lanen Study</u>	<u>GAO Adjustment</u>	<u>Revised estimate</u>
		----- (millions) -----		
Philadelphia with wage board reform	Basic shipbuilder conversion and contract modi- fication allow- ance	\$ 341.8	\$ 22.2	\$ 364.0
	Projected esca- lation	0	30.2	30.2
	Government-fur- nished materi- al, services, and test	67.0	0	67.0
	Military person- nel	85.6	-3.6	82.0
	Corporate taxes lost	0	14.2	14.2
	Total	\$ 494.4	\$ 63.0	\$ 557.4
Newport News	Basic shipbuild- er conversion and contract modification allowance	\$ 343.9	\$-65.8	\$ 278.1
	Projected esca- lation	0	38.0	38.0
	Government-fur- nished materi- al, services, and test	67.0	0	67.0
	Military person- nel	76.2	5.8	82.0
	Contract admini- stration	3.4	0	3.4
	Total	\$ 490.5	\$-22.0	\$ 468.5

Basic shipbuilder conversion costs

As indicated in our report and the Lanen study, this cost element includes the total estimated costs for shipbuilder labor, overhead, material, and basic change orders expressed in dollars for the base month period. For Newport News, the amount also includes profit.

Labor and overhead

We increased the Philadelphia labor and overhead cost by \$22.2 million and reduced the Newport News costs by \$65.8 million.

We increased the Philadelphia labor and overhead costs because Lanen

- used a lower number of total labor days than the Navy's estimates,

- used a lower labor day rate than the Navy's estimates,

- used a higher amount for shipbuilder material than the Navy's estimates,

- used a lower factor for contract modification allowance than provided by Navy guidance.

We decreased the Newport News labor and overhead costs because Lanen

- used a lower number of total days than the Navy's estimates,

- assumed that the ship's crew would do 295,000 labor days of work, whereas 395,000 labor days should have been used to make it consistent with the Philadelphia assumption,
- used the Navy's original labor day rates rather than GAO's rates which are also used by the Navy in its latest cost study,
- used a higher amount for shipbuilder material than the Navy's estimates,
- used a lower factor for contract modification allowance than provided by Navy guidance.

Projected escalation

Lanen excluded this cost element from his study stating

"To the extent that the price increases are due to inflation and not to changes in relative price, this category is not necessary for a cost analysis since the analysis can be conducted in real terms."

We added back the estimated escalation costs of \$30.2 million for Philadelphia and \$38 million for Newport News. This cost element should be included to reflect the total estimated costs for the duration of the program.

Military personnel costs

We decreased the estimated military personnel costs by \$3.6 million at Philadelphia and increased them by \$5.8 million at Newport News. We used the Navy's latest estimates of the military personnel costs using a ship's crew work package of 395,000 labor days of work at both locations.

Lanen used 295,000 labor days of work by the ship's crew at Newport News because of the Newport News position that it would not want to use the crew to the extent planned at Philadelphia.

The Navy is preparing two work packages--one for the shipyard and the other for the ship's crew. According to the Navy, the ship's crew work package will be 395,000 labor days and it would not use the crew for the Lanen alternative. The latest Navy study recognizes that there are 2 alternatives for Newport News--use of the crew for 395,000 and no crew. We believe use of the crew should be used for the cost comparison because it makes the same assumptions as for Philadelphia.

Corporate taxes lost

Lanen excluded this cost element from his study stating that "this is not a relevant cost." We increased the Lanen cost estimate for Philadelphia to include this cost element. OMB Circular A-76 specifies that the total

costs to the Government should be included and identifies this cost element as one which should be included. We agree with the OMB position.